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Pharmaceutical Issues in Perspective

EU biotech: united we stand, divided we fall

In the first of two articles, Claude Allary and Catherine Pichereau look at the results of a survey examining why there are so few biotech consolidations in Europe, and suggest ways to increase their number

Europe's biotech industry is blessed with many advantages, including fundamental research, close links between academia and industry, and public financial support at national and continental levels. Despite this, few EU companies compared with their US counterparts make the transition from science project to commercial business proposition. One explanation for this is the underuse of consolidation as a strategic development tool, and the ramifications of this will be far-reaching. The European biotech industry of tomorrow will be built on the development of today's private biotechs.

Although public biotech indices have rebounded in the last year, few European biotechs have been able to take advantage of the short-lived IPO window (Basilea Pharmaceutica and Ark Therapeutics are only two examples versus the dozen or so US IPOs this year). This is particularly surprising as there are more than 1,800 potential IPO candidates among Europe's private biotechs, compared with 1,500 in the US. So why the bottleneck?

A key problem is that the private European biotech sector is still immature and fragmented. Many companies remain either early drug development firms with – at best – preclinical compounds, or platform companies with no compounds at all. Profitability, however, is an issue for investors, who assign little if any value to such companies and are unwilling to inject further capital into them. The irony is that venture capitalists do have money to invest, but their criteria for doing so have tightened since 2001 and they no longer fund companies without a clear path to profitability.

Consolidation provides a method of transforming science start-ups into profit-focused commercial propositions. In the eyes of investors it allows companies to become stronger candidates, and move closer to an IPO. There have been signs of consolidation, but, as Figures 1 and 2 reveal, current activity is mostly being driven by 'rescue' M&A, in which survival is the key deal driver. In fact, several recent deals have been accompanied by a round of financing, while some transactions were even motivated by the attractive cash balance of the target.

But if the strategic benefits of consolidation are clear, why are there relatively few strategic deals? There is no simple answer, but listed below are some of the principal factors that may be hampering consolidation in Europe and a series of recommendations that could help solve some of these problems. Both findings and recommendations are based on a Bionest survey conducted between May and June this year.

Management

Few biotechs reach maturity without engaging in some sort of consolidation so management should see M&A as being essential to company development. However, management itself is often a significant barrier to M&A. One reason for this is that CEOs often do not have the skills or experience necessary to implement a successful consolidation. Many young companies are managed by their owners or founders, whose skill sets are often scientific, whereas in other sectors they would be business-related. Consequently, biotech CEOs may overlook their shareholders' interests. Indeed, when scientific founders are in charge, there is an 'emotional factor' in M&A discussions, as they feel their personal research is being valued. Similarly, when investigating potential targets, their evaluation criteria are often unrealistically tough – the so-called 'nobody-can-beat-me' syndrome. CEOs of companies being investigated as potential targets will tend to reject any offers on the grounds that the valuation is

Date	Acquisitor	Description	Target	Description	Amount (Eur million)	Rationale
January 2004	**Nadag (Germany)**	Drug discovery company	**SiREEN (Germany)**	Drug discovery company	na	Complementary technologies Parallel fundraising
November 2003	**DeveloGen (Germany)**	Biology-driven drug discovery company focused on diabetes and obesity	**Peptor (Israel)**	Drug discovery company immunotherapeutic drugs (diabetes and autoimmune)	na	Complementary technologies Clinical pipeline Parallel fundraising
July 2003	**Alnylam (US)**	Biotech company focused on RNAi-based therapeutics	**Ribopharma (Germany)**	Biotech company focused on RNAi-based therapeutics	na	Complementary technologies Parallel fundraising
July 2003	**BioFrontera (Germany)**	Technology platform company	**BioLeads (Germany)**	Technology platform company	na	Complementary technologies Parallel fundraising
January 2003	**Sense Proteomics (UK)**	Technology platform company	**Procognia (UK)**	Technology platform company	na	Complementary technologies Parallel fundraising

Figure 1: Recent M&A transactions with parallel fundraising.

not good enough. Additionally, a sale is often seen as a failure.

Even when companies recognise their lack of internal skills, they may still be unable to find them elsewhere. The relatively small size and immaturity of the industry means there is a limited corpus of experienced biotech managers, and nowhere near the critical mass of 'recycled' professionals with broad transaction knowledge that is one of the key strengths of the US biotech industry. The UK, with its more developed biotech sector and closer links to the US, has significant advantages in this respect over continental Europe, where attracting management talent from abroad remains tough.

Even when companies engage credible managers they are rarely sufficiently incentivised to pursue consolidation opportunities. The results of a 2003 study which assessed incentives for carrying out M&A among UK biotech CEOs are shown in Figure 3. More than 90% of the CEOs interviewed acknowledged that consolidation is often a critical step to company survival. And 70% thought that changes in the structure of compensation of senior executives are needed, with a sizeable minority believing they were no longer sufficiently motivated to encourage consolidation. Furthermore, although issues such as notice periods and stock options relating specifically to M&A were acknowledged to be important, contracts rarely recognised this.

Management maketh M&A. If senior managers cannot maximise shareholder value, their credibility and reputation will be damaged, possibly permanently. It is in their interests to demonstrate they have considered every option for their company, including consolidation. CEOs should be entrepreneurs, deal-makers who will do whatever it takes to make their organisation successful. What better example than Dr Peter Fellner who, only months after becoming chairman, had transformed British Biotech with the RiboTargets/ Vernalis transaction. When he was CEO of Celltech, Fellner presided over a string of transactions – notably the Medeva/ Chiroscience deal – that transformed the group into one of Europe's major players. The sector needs more individuals who understand that a CEO's job goes beyond the traditional 9-to-5 Monday-to-Friday commitment, individuals who are ready to travel, even to move. This level of commitment is widespread in the US, but has yet to take hold in Europe.

Stop waiting for Mr Right. Every CEO should understand that there may be no perfect match for his company. Most acquisitions come with 'non-core' assets, but value can be created nonetheless, bringing the elusive IPO one step closer. Of course, deals rarely yield enormous value, but as long as some is created the transaction should be approved. The new company should be seen as a means to access the next phase of value generation, and this should not be jeopardised. Holding out for a more attractive deal also increases the risk of a fire sale as the cash pile dwindles.

The board sets the agenda. It is difficult to overstate the importance of the management team, but the board also plays a vital role. It should regularly evaluate the skill-set required to develop the business to ensure the right management team is in place and, if not, appropriate changes must be made. Attracting the right external talent may require significant packages but the board should not shy away from sanctioning this investment. Furthermore, once the right people have been found, their compensation packages should be tailored to encourage M&A.

Valuation

Biotech valuation sparks extensive debate. For any sector, valuation of companies or products involves some degree of subjectivity, in addition to the application of more objective financial modelling. The discounted cash flow (DCF) method remains the most widespread tool, however flawed. The trouble is, biotechs must often wait more than ten years before returning a profit, so a large proportion of their valuations are based on sales and profit assumptions. This results in a range of values rather than a precise number.

Additionally, unlike public companies, for whom market performance provides useful daily reference points for valuation, private companies are only infrequently subjected to formal valuation – they will have a post-money valuation from their last financing round, or perhaps a valuation from a recent M&A due diligence exercise.

These factors have a clear impact on consolidation: reaching agreement on valuation is crucial to any transaction. For biotechs, perhaps more than any other sector, the degree of subjectivity involved, combined with a lack of recent valuation, makes it easy to see how the two sides of a transaction may remain stubbornly irreconcilable.

Think Newco. While accepting bad terms in any transaction implies dilution for investors, there is currently an over-emphasis on the valuation of the pre-deal components. More emphasis should be placed on the new company's ability to

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Date	Acquisitor	Description	Target	Description	Amount (Eur million)	Rationale
December 2003	**Kiadis (Netherlands)**	Drug discovery company	**Selact (Netherlands)**	Chemistry company	na	Complementary technologies Cash
October 2003	**Astex (UK)**	Fragment-based drug discovery company	**metaGen (Germany)**	Drug development company focused on oncology	25	Complementary technologies Stronger relationship with Schering AG Parallel fundraising Cash
August 2003	**Xenova (UK)**	Drug development company	**KS Biomedix (UK)**	Drug development company focused on oncology	21	Stronger focus on oncology Cash
June 2003	**Seattle Therapeutics (US)**	Drug development company focused on oncology	**Novuspharma (Italy)**	Drug development company focused on oncology	205	Complementary products European footprint Cash
March 2003	**British Biotech (UK)**	Drug development company	**Ribo Targets (UK)**	Drug discovery company	48	Drug discovery capabilities Cash

Figure 2: Recent M&A transactions with a cash motive.

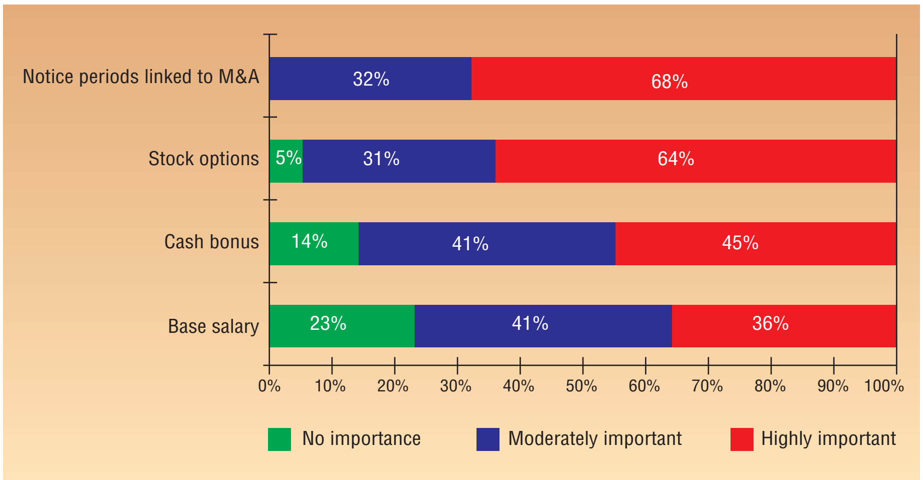

Figure 3: How CEOs rate pay and benefits as incentives for increasing M&As. Source: Ajlon Executive Healthcare

generate value over the longer term. A key rationale should be that the Newco has more of the required elements of a successful biotech than either of its parents and its value generation potential should consequently be greater. The focus should be on post-deal contributions rather than pre-deal components. Instead of thinking about company A or company B's standalone value, the focus should be on the new company's worth, and how much A brings to it compared with B. The question then becomes: 'How much of this entity does my company deserve?'

Timing and investor groups

Even when agreement with external parties has been reached, a lack of consensus among investors can still be a significant barrier to an M&A deal. Biotech shareholdings are typically split between management, business angels, venture capitalists and strategic investors (corporate bodies, such as pharma companies). Each group has different objectives. Strategic investors have a longer term horizon – they are not pressurised to exit investments and look for liquidity events after a certain period – but want to ensure the proposed transaction will maximise company value. Venture capitalists, however, sometimes prefer to exit investments, even when that results in a loss. In 2001, many biotech venture capitalists were in this situation, unable to exit their investments and ready to support a transaction valuing the company at a significant discount.

These differences in agendas are further aggravated by timing differences within similar groups of investors. A company considering M&A after several rounds of financing may find it difficult to convince all its investors of the benefits of a transaction. Those who invested at the latest financing round are unlikely to be in favour as their return would be limited. In contrast, investors in earlier rounds are more likely to be looking for an exit, and so could support a deal. When there is only a limited number of shareholders, such that each one has a potentially significant share of voice on the board, their interests can be particularly restrictive.

Management should make the case. Persuading all the stakeholders that a transaction makes sense can be a challenge. The significance of timing in M&A makes this even more problematic. But the management team should be able to demonstrate to investors a strong rationale for the transaction. Of course, as mentioned earlier, if management is not incentivised to carry out M&A, they may not be motivated enough to convince the stakeholders.

The management should find it much easier to convince a varied board, which represents a range of investors' interests, of an M&A's merits. Although biotechs, with their limited finances, may find it difficult to be selective about investors and limit their influence, a balanced representation is important to the company's long-term development and should be an objective.

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European harmonisation

An often under-stated issue is that Europe is still nowhere near homogeneous in terms of business. Divergent national contract laws and the legal complexity of these divergences create uncertainty and increase transaction costs. These are disincentives to cross-border dealmaking in companies of any size, but they hit private companies hardest even though their deals are relatively small. Language and cultural differences also remain a barrier, although they are becoming less important. To top it all, EU capital markets are not yet consolidated into one exchange as in the US, which has a significant impact on overall liquidity. In an era of increasingly mobile capital, this makes Europe even less attractive to investors.

The European Commission's ongoing harmonisation of contract law will facilitate cross-border M&A, but implementation is likely to be protracted. Consequently, cross-border European deals are likely to remain expensive, difficult and time consuming, reducing the number of effective alternatives open to CEOs.

European diversity is not necessarily a deal-breaker. The lack of harmonisation is likely to influence the execution of a transaction rather than its fundamental logic. Although cross-border transactions are, on average, longer and more expensive than national ones, this can be taken into consideration when modelling them. Therefore, if a deal is likely to create value, any harmonisation issues will already have been factored in.

There are no easy solutions to some of the problems that impede consolidation, whereas for others, the adoption of a more pragmatic attitude among managers could yield significant benefits. And, unlike many strategies in the biotech sector, these recommendations would not require significant capital expenditure. The results for investors could be far-reaching. SM

The next article will examine the likely course of European biotech consolidation, predict the success or failure of more than 200 private biotechs and provide recommendations on how biotechs can benefit from joining forces with others.

•Claude Allary is managing partner and Catherine Pichereau a senior consultant at Bionest Partners, a professional services and M&A boutique that provides operational consulting services to innovative healthcare companies. They are both based in France.

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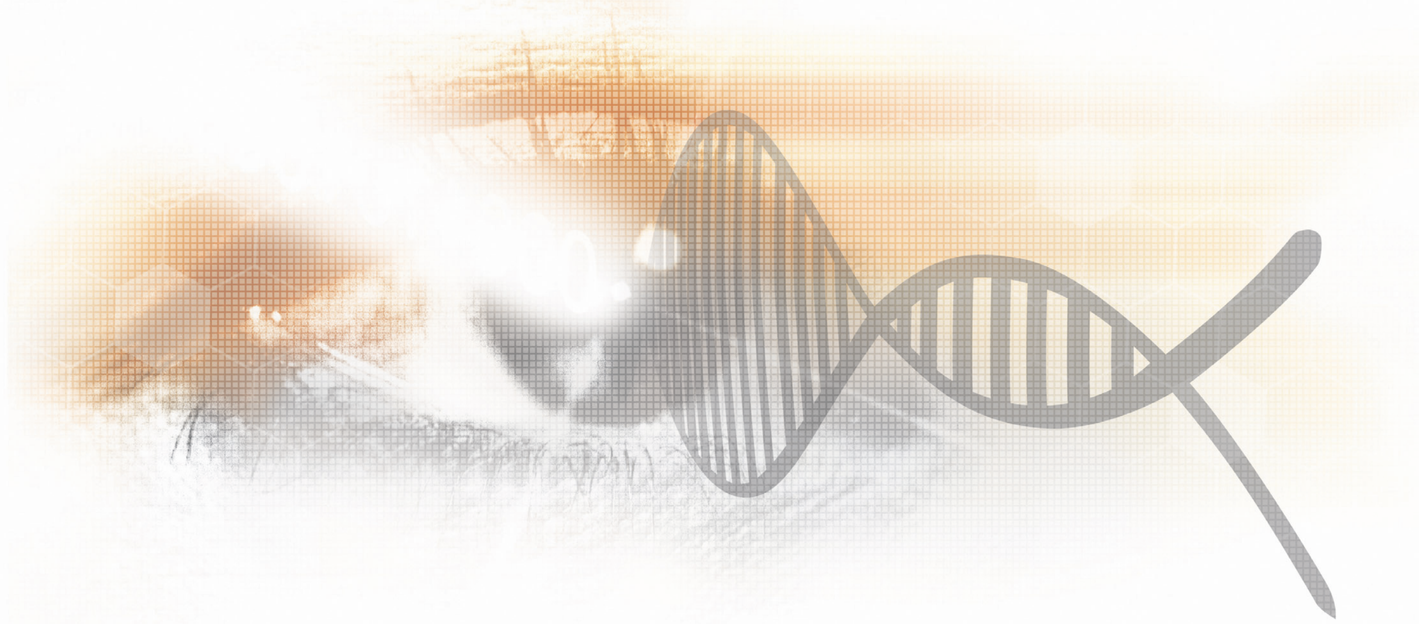

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